TAX EXPENDITURES: CURRENT ISSUES AND FIVE-YEAR BUDGET PROJECTIONS FOR FISCAL YEARS 1984-1988

The Congress of the United States
Congressional Budget Office

PREFACE

The Congressional Budget Office (CBO) is required by Section 308(c) of the Congressional Budget Act of 1974 to issue a report annually that projects tax expenditures for each of the next five fiscal years. This report fulfills that statutory requirement for fiscal years 1984 to 1988.

The report also reviews the difficulties in defining and measuring tax expenditures. Different interpretations of these issues may produce different tax expenditure lists. The report compares the revenue loss and outlay equivalent approaches to estimating tax expenditures and outlines the differences between the recent Congressional and Administration tax expenditure lists. Finally, the report surveys the use of tax expenditure lists in other countries to show how other governments have applied this concept. These comparisons help to demonstrate the difficulties involved in defining and measuring tax expenditures and to illustrate the usefulness of information on tax expenditures.

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SUMMARY

Since the tax expenditure concept was first developed in the 1960s, the United States and several other countries have found that it can be a useful tool for government budgeting and policy analysis. When all the tax expenditure provisions are shown in one place, policymakers can make decisions with a better understanding of the total allocation of government resources among policy objectives, economic sectors, and categories of beneficiaries. By providing information on the amount of government subsidy delivered through the tax system, tax expenditure lists correspond to the listings of outlay programs in federal budgets. Review of both direct subsidies and tax expenditures may be especially useful when a government is seeking to reduce large federal deficits.

DEFINITION

Tax expenditures are provisions in the tax code that provide incentives for particular kinds of activities or that give special or selective tax relief to certain groups of taxpayers. The investment tax credit, for example, provides an incentive for firms to invest in business machinery and equipment, while the extra $1,000 personal exemption for those age 65 or over gives tax relief to this particular group of taxpayers. Through these allocations of government tax resources, tax expenditures are comparable to direct spending programs. The most recent list of tax expenditure estimates, compiled by the Joint Committee on Taxation and the Congressional Budget Office (JCT/CBO), contains 105 provisions and is presented in Appendix A.

Certain features of an income tax are considered integral parts of the basic structure of the tax and therefore are not viewed as tax expenditures, which are defined as exceptions to these basic tax rules. The integral features include the general rate schedules and exemption levels, the general rules defining who is subject to tax and what accounting periods should be used, and deductions for the cost of earning income.

Although the tax expenditure concept appears straightforward, a number of complicated definitional issues surround both the selection and measurement of tax expenditures. One fundamental problem is choosing a consistent set of basic tax rules--called "reference" tax rules--as the standard against which tax expenditures are selected and measured. Although there is general agreement about the reference tax rules, some tax analysts consider several provisions to be part of the reference tax structure while others do not. Until recently, the Congress and the Administration have generally concurred on which provisions should be considered part of the basic tax structure and which should be viewed as tax expenditures.

MEASUREMENT

The tax expenditure estimates provided in this report are measured on the basis of their "revenue loss." The revenue loss from each tax expenditure is estimated by comparing the revenue raised under current law with the revenue that would be raised if the provision had never existed, assuming that both taxpayer behavior and all other tax provisions remain the same as they are under current law. This is not an estimate of the amount of revenue that would be gained if the provision were repealed, since repeal of the provision probably would change taxpayer behavior in ways that could significantly reduce the revenue gain. Furthermore, the estimates measure only the isolated effect of each provision. Interactions among different tax expenditures and other tax provisions could make the revenue gain from repealing several tax expenditures together either more or less than their repeal separately. It is, therefore, difficult to measure how much revenue the federal government does not collect because of each tax expenditure provision. The amount of revenue the government collects under existing law can be observed directly; the amount of revenue that would be collected under some different law can never be observed directly and can only be estimated.

While estimates of individual tax expenditures are useful in quantifying the budgetary effect of each provision, the arithmetic total of all the tax expenditure estimates has significant limitations. Since the cost of each tax expenditure is estimated by determining how much additional revenue would be collected if the provision did not exist, adding together estimates of several different tax expenditures does not produce a valid estimate of the cost of the group as a whole. For example, as a result of changing any one tax expenditure provision, more taxpayers might use the standard deduction instead of itemizing their deductions. On the other hand, some taxpayers' taxable income might increase and therefore be taxed at higher marginal rates. When more than one tax expenditure provision is changed, the total revenue effect of behavioral and economic interactions should be taken into account.

DIFFERENCES BETWEEN THE ADMINISTRATION AND THE CONGRESSIONAL TAX EXPENDITURE LISTS

Definitional Issues

Despite the general agreement that exists about which provisions in the tax code represent tax expenditures, some cases are not clear-cut. Depending on how the basic tax rules are defined, certain provisions may or may not be considered tax expenditures. For example, the Accelerated Cost Recovery System (ACRS) is counted as a tax expenditure by the Congressional Budget Office and the Joint Committee on Taxation, but not by the Administration. Because the CBO and the JCT assume a different set of basic tax rules than does the Administration, the CBO/JCT list includes 13 provisions not included by the Administration.

The most important distinction between the Congressional and Administration baseline, or reference, tax rules is that the CBO and the JCT use a broader definition of income to define the tax base. Under the Congressional reference tax rules, most income, from whatever source, is assumed to be subject to tax. Any provision that reduces this income measure or reduces the tax otherwise payable is considered a tax expenditure.

The Administration takes a different approach in defining tax expenditures. Under the current Treasury rules, a provision must satisfy two conditions in order to be classified as a tax expenditure:

- The provision must be "special" in that it applies to a narrow class of transactions or taxpayers; and
- There must be a general provision to which the "special" provision is a clear exception. (See The Budget of the United States Government, Fiscal Year 1984, "Special Analysis G," p. G-5.)

These conditions obviate the need to define the base of a conventional income tax. Various provisions are compared to the set of general rules currently in the tax code in order to determine whether they are "special." Although the methods for defining tax expenditures used by the CBO and the JCT and the Treasury are similar, they result in differences when a general rule in current tax law, such as ACRS, differs from the rule that prevails under the JCT/CBO definition of the basic income tax rules.

Measurement Issues

The CBO and the JCT estimates of tax expenditures are based solely on the amount of revenue that the federal government forgoes as a result of special provisions in the tax code. In contrast, "Special Analysis G" of the 1984 budget presents estimates of tax expenditures calculated according to the "outlay equivalent" concept, as well as the traditional revenue loss estimates. The outlay equivalent approach estimates a tax expenditure's cost as the amount of direct outlays that would be required to provide the same after-tax benefit. Outlay equivalents are estimated in a similar manner to revenue loss estimates, except that they are often increased to reflect the fact that a comparable outlay program would result in additional taxable income. The Administration has added this information because the outlay equivalent approach provides estimates of tax expenditures that more closely correspond to estimates of direct expenditures.

TAX EXPENDITURE BUDGETS IN OTHER COUNTRIES

Government analysts in several countries have developed tax expenditure lists to help emphasize the total level of government resources devoted to various sectors of their economies and to provide more information for long-term planning. The Federal Republic of Germany was the first country to supply a comprehensive list of tax subsidies in its budget documents, after a 1967 law required biennial reports on direct and tax subsidies. The United States has published annual tax expenditure lists since 1968 and has included a list in its budget documents every year since 1976, as required by the Congressional Budget Act of 1974.

In the 1970s, high deficits forced several other governments to use new institutional procedures, such as tax expenditure budgets, to help control government spending. Austria has published an annual report on direct and tax subsidies similar to the German report since 1978. Canada, the United Kingdom, France, Spain, and Australia first published tax expenditure lists or more general lists of tax reliefs and incentives in 1979 and 1980. In Japan, estimates of "special tax provisions" (mainly tax expenditures) are now usually provided to the legislature at budget time, even though these estimates are not required by law. Government tax analysts have also begun to develop tax expenditure lists in Belgium, Ireland, the Netherlands, New Zealand, and Sweden.

CHAPTER I. INTRODUCTION

DEFINITION

Tax expenditures are provisions in the tax code that provide incentives for particular kinds of activities or that give special or selective tax relief to certain groups of taxpayers. The investment tax credit, for example, provides an incentive for investment in business machinery and equipment, while the extra $1,000 personal exemption for those age 65 or over gives tax relief to that group of taxpayers. In this way, tax expenditures are comparable to direct spending programs that provide special subsidies to certain groups or activities. Tax subsidies, like direct spending programs, are used by the government to allocate resources toward certain activities. Appendix A presents the most recent list of tax expenditure estimates compiled by the Joint Committee on Taxation and the Congressional Budget Office. The listing contains 105 provisions.

The definition of tax expenditures used in this report is based on the distinction between the basic structural features of an income tax and those provisions that are exceptions to these basic rules. The basic features are generally referred to as the "reference" tax rules. These rules include the general rate schedules and exemption levels, the general rules defining who is subject to tax and what accounting period should be used, and all deductions for the costs of earning income. Since the reference tax rules are an integral part of the income tax, they are not considered tax expenditures, but rather form the standard against which tax expenditures are selected and measured. Although there is general agreement about the reference tax rules, tax analysts do disagree about a few provisions. While some analysts consider these provisions as part of the basic tax structure, others define them as tax expenditures.

It is sometimes difficult to distinguish between tax expenditures and provisions that are part of the basic, or reference, structure of the tax code. The deduction for two-earner married couples, for example, is treated as a tax expenditure in the Joint Committee on Taxation/Congressional Budget Office (JCT/CBO) list, while it is not included by the Administration. If the Congress had adopted a broader approach to this problem of the "marriage penalty" and allowed married couples to be taxed separately at the lower rates applicable to single persons, the JCT/CBO would probably have regarded the change as a modification of the basic tax structure rather than as a tax expenditure.

Until recently, there has been general agreement between the Congress and the Administration about which provisions should be considered part of the reference tax structure and which provisions should be considered tax expenditures. In its last two tax expenditure budgets, however, the Administration has adopted a different and somewhat narrower definition of tax expenditures than the one used by the Joint Tax Committee and the Congressional Budget Office. The differences between the Administration and the JCT/CBO tax expenditure budgets are discussed in more detail in Chapter II and in Appendix C.

MEASUREMENT

Revenue Losses and Outlay Equivalents

Tax expenditure estimates presented in this report are measured by the JCT/CBO on the basis of their "revenue loss,"--that is, the amount of revenue that the government forgoes as the result of the special provisions in the tax code. "Special Analysis G" of the U.S. Government Budget for 1984 presents estimates of tax expenditures calculated according to the "outlay equivalent" concept, as well as the traditional revenue loss estimates.

The revenue loss from each tax expenditure is estimated by comparing the revenue raised under current law with the revenue that would be raised if the specified provision did not exist, assuming that both taxpayer behavior and all other tax provisions remained the same. This is not an estimate of the amount of revenue that would be gained if the provision were repealed, since repeal of the provision would probably change taxpayer behavior in ways that would generally reduce the revenue gain. Furthermore, the individual revenue loss estimates for several provisions cannot be added together because interactions among different tax expenditures and other tax provisions could make their joint revenue loss either more or less than their sum.

Under the revenue loss approach, difficult measurement problems arise in estimating how much revenue the federal government does not collect because of each tax expenditure provision. The amount of revenue the government collects under existing law can be observed directly; the amount of revenue that would be collected under some different law can never be observed and can only be estimated. The future effects of spending programs and general tax rules must also be estimated, of course, but eventually there are actual outlays and tax collections against which to compare the estimates. Since a tax system without tax expenditures is an abstraction, the revenue yield of such a system cannot be observed and, therefore, can only be estimated imprecisely.

The outlay equivalent approach estimates a tax expenditure's cost as the amount of direct subsidy that would be required to provide the same benefit. Outlay equivalents are estimated in a manner similar to revenue loss estimates, with one exception: they are often increased to include the income taxes resulting from the additional taxable income frequently produced by comparable outlay programs. (This methodology is referred to in tax jargon as "grossing up.") The outlay equivalent, therefore, includes not only the subsidy amount, but also the extra amount that would be paid in income tax by the recipients of the benefit. The Administration has added this information because the outlay equivalent approach makes tax expenditure estimates more consistent with direct expenditure estimates, thus permitting comparison on a similar basis.

The exemption of certain housing and meal allowances for military personnel is one example of a tax expenditure that needs to include the additional income taxes to reflect its outlay equivalent. The revenue loss estimate for this provision is based on the tax that would be owed if the value of these benefits were included in the taxable income of the recipients. By contrast, the outlay equivalent estimate reflects the additional pre-tax income that military personnel would have to be paid to raise their income after federal taxes by the amount of the benefits. The outlay equivalent amount for this exemption can be compared with other defense outlays on a consistent basis.

If a tax expenditure were actually replaced by a direct outlay, the resulting increase in money income might well be subject to state and/or local taxes. In that case, the outlay equivalent would not actually leave the recipient with the same total income after all taxes as was provided by the tax expenditure. Therefore, the outlay expenditure concept does not necessarily provide an estimate of the full cost to the federal government of replacing a tax expenditure with a direct benefit of the same value to the recipient.

Arithmetic Totals

While estimates of individual tax expenditures may permit useful comparisons with similar direct outlays, the arithmetic total of several or of all the tax expenditure estimates has significant limitations. Since the cost of each tax expenditure is estimated by determining how much additional revenue would be collected if the provision did not exist, some special problems are introduced when more than one tax expenditure is involved. If three or four tax expenditures that take the form of personal deductions did not exist, for example, more taxpayers would use the standard deduction (zero bracket amount), and the net revenue cost would be less than if the deductions were estimated separately and then summed.

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The standard deduction would absorb part of the cost that would otherwise be assigned to the tax expenditures. On the other hand, if three or four tax expenditures that took the form of exclusions from income no longer existed, more income would be taxed at higher marginal tax rates, so that the cost of several exclusions would be more than if the exclusions were individually estimated and then added together. The simple aggregation of several tax expenditures discussed here would not provide an accurate estimate of their joint cost.

RECENT CHANGES IN TAX EXPENDITURES

Some major changes in tax expenditures were enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA, P.L. 97-248). Thirteen provisions of the act reduced existing tax expenditures; two of these--the alternative minimum tax for individuals and the reduction in business preference items--applied to a wide variety of tax expenditures. Also, two provisions of the act increased tax expenditures, with the major increase coming from an expansion and extension of the targeted jobs tax credit. As shown in Table 1, the tax expenditure changes in TEFRA totaled an estimated net increase in projected revenues of $54.6 billion over fiscal years 1984-1986. These changes are reflected in the tax expenditure estimates included in Appendix A.

The only new tax expenditure enacted since TEFRA is the tax credit for orphan drug research. A provision in the Orphan Drug Act of 1983 (P.L. 97-414) provides for a 50 percent tax credit for expenses of qualified clinical testing of drugs to treat certain rare diseases or conditions. The provision will result in an estimated revenue loss of $40 million over the 1984-1986 period and is scheduled to expire at the end of 1987.

In addition, the Social Security Amendments of 1983 (P.L. 98-21), enacted in April, include provisions for taxation of certain Social Security and railroad retirement benefits that reduce two existing tax expenditures. According to the new amendments, if the sum of half of Social Security benefits plus adjusted gross income (including tax-exempt bond interest) exceeds a certain threshold ($25,000 for single filers and $32,000 for couples filing jointly), the portion of Social Security benefits that exceeds the threshold is added to taxable income. Some railroad retirement benefits are treated in the same way. These reductions in the income tax exclusions for Social Security and railroad retirement benefits will raise revenues by about $7 billion over fiscal years 1984-1986. The changes are not reflected in the tax expenditure list in Appendix A, however, because the amendments were enacted after the list was compiled.

TABLE 1. ESTIMATED REVENUE EFFECTS OF CHANGES IN TAX EXPENDITURES IN THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, FISCAL YEARS 1983-1987 (In millions of dollars)

Change	1983	1984	1985	1986	1987
Reductions in Tax Expenditures					
Alternative minimum tax	a	+659	+701	+741	+729
Medical deduction	+272	+1,788	+1,671	+1,795	+1,947
Ten percent casualty deduction floor	---	+666	+734	+800	+880
Reduction in corporate preference items	+515	+936	+948	+918	+995
Investment tax credit basis adjustment	+362	+1,374	+2,658	+4,109	+5,579
Limit ITC to 85 percent of tax liability	+152	+259	+213	+178	+164
Accelerated depreciation--1985 and 1986	---	---	+1,541	+9,907	+18,442
Construction period interest and taxes	+555	+1,179	+1,206	+1,084	+819
Modifications to pre-ERTA and safe-harbor leasing rules[b]	+1,036	+2,649	+4,252	+5,496	+7,000
Limit on U.S. possessions credit	+201	+428	+473	+516	+559
Private purpose tax-exempt bonds	+63	+261	+539	+748	+1,076
Pension provisions	+194	+780	+870	+970	+1,058
Reduction to $18,000/12,000 of income threshhold for tax on unemployment compensation benefits	+763	+734	+611	+618	+650
Subtotal	+4,113	+11,713	+16,417	+27,880	+39,898
Increases in Tax Expenditures					
Targeted jobs credit	-182	-551	-591	-271	-54
National Research Service Awards	-8	-7	-4	-2	a
Subtotal	-190	-558	-595	-273	-54
Total	+3,923	+11,155	+15,822	+27,607	+39,844

SOURCE: Summary of the Revenue Provisions of H.R. 4961 (The Tax Equity and Fiscal Responsibility Act of 1982), prepared by the Joint Committee on Taxation, August 24, 1982.

a. Negligible.

b. ERTA = Economic Recovery Tax Act of 1981.